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Letters to the Editor

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AICPA

In the KNOW

BV STANDARDS: THE POSITIVE SIDE

By James R. Hitchner, CPA/ABV, ASA

The following article is reprinted with permission from Jim Hitchner's Financial Valuation and Litigation Expert, *December 2007/January 2008. For more information about this bimonthly professional journal, visit* www.valuationproducts.com. *The author was one of four members of the AICPA Business Valuation Standards Writing Task Force, serving six years up to the June 2007 release of the standards.*

In the movie "Steel Magnolias," Oscar-winning actress Olympia Dukakis said, "If you don't have anything nice to say about anybody, come sit by me." Perfect words for what is going on in the world of business valuation (BV) standards. For the past few months, much public anxiety has been vented about the many changes in BV standards. Unfortunately, as usual, the negative side is the loudest.

Yes, there have been changes, particularly the introduction of the AICPA Business Valuation Standards and changes in the Uniform Standards of Professional Appraisal Practice (USPAP) developed by the Appraisal Foundation, and in the National Association of Certified Valuation Analysts (NACVA) standards. In addition, members of the American Society of Appraisers (ASA) and the Institute of Business Appraisers (IBA) must also comply with these organizations' standards.

We have heard how different the standards of these five U.S. valuation associations/groups are. Yes, there are differences. However, little attention has been given to how similar most of these standards really are.

Let's see if we can get the positive side to be as loud as the negative side. This article compares the standards of the AICPA, NACVA, and USPAP. In a future issue, we will compare the ASA and IBA standards to the other standards. Please note that there is also the potential for substantial impact from the standards issued by the Financial Accounting Standards Board and the International Standards Board. But, we have to start somewhere, so we'll focus here on the U.S. standards first. We hope these comparisons provide helpful guidance to assist valuation analysts to comply with whatever standards to which they are required or choose to adhere.

SSVS NO. 1 AND NACVA'S PROFESSIONAL STANDARDS

Let's begin with the easy one: AICPA's Statement on Standards for Valuation Services (SSVS No. 1) compared with NACVA's Professional Standards. Based on the fact that NACVA is primarily made up of CPAs, NACVA is in the process of adapting to the AICPA standards and currently has a draft issued of their new standards. NACVA's November 14, 2007 "Summary of Changes to NACVA's Standards," sent to all NACVA members, states that, "Changes were made to address conflicts between the AICPA's Statement on Standards for Valuation Services (SSVS No. 1) and NACVA's previous Standards, and intend to eliminate such conflicts and draw parity between the two. This was our objective." Bottom line—they are very similar.

SSVS AND USPAP

Now, let's compare SSVS No. 1 with USPAP (2008–2009) using USPAP language from Standards 9 and 10 (Appraisal Report only). In a future issue, we will compare the USPAP Restricted Use Appraisal Report with the SSVS No. 1 Summary Report. USPAP references are to page numbers; SSVS No. 1 references are to paragraph numbers. First, the development standards.

Standard 9: Business Appraisal, Development

- Identify the problem to be solved: USPAP p. U68; SSVS No. 1, paragraphs (par.) 13, 16, and 17
- Determine the scope of work: USPAP p. U68; SSVS No. 1, par. 12, 13, 19, 25, and 44
- Complete the research and analysis steps necessary: USPAP p. U68; SSVS No. 1, par. 11, 23, 25, 27, and 44

  Note: SSVS No. 1 uses the term *research* only in paragraph 33c when addressing intangible assets. However, the other paragraphs listed here are quite detailed about, for example, analyses and procedures.
- Appraiser is aware of, understands, and correctly employs recognized approaches, methods, and procedures necessary: USPAP p. U68; SSVS No. 1, par. 11, 12, 31, and 44
- Did appraiser commit a significant error or a series of errors: USPAP p. U68; SSVS No. 1, par. 11 and 12

  Note: SSVS No. 1 does not specifically mention the word *error*. However, it does present information on the need for professional competence. USPAP also has the Competency Rule on p. U11.
- Did the appraiser render appraisal services in a careless or negligent manner: USPAP p. U68; SSVS No. 1, par. 11 and 12

  Note: SSVS No. 1 does not specifically mention the words *careless* or *negligent*. However, it does present information on the need for professional competence.
- Identify the client, intended users, and intended use and do not allow a client's objectives to cause bias: USPAP p. U68; SSVS No. 1, par. 12, 13, 14, 15, and 25
- Identify the standard, definition, and premise of value: USPAP p. U68; SSVS No. 1, par. 12, 25, and appendixes B and C
- Identify the effective date of the appraisal: USPAP p. U69; SSVS No. 1, par. 12, 25, and appendix B

  Note: SSVS No. 1 uses the terms *effective date* and *valuation date* interchangeably.
- Identify the characteristics of the subject property including:
  - —Subject business enterprise or intangible asset: USPAP p. U69; SSVS No. 1, par. 12, 13, 25, 27, and 44
  - —The interest in the business enterprise, equity, asset, or liability: USPAP p. U69; SSVS No. 1, par. 12, 13, 23, 25, 27, 28, and 44
  - —All buy/sell and option agreements, investment letter stock restrictions, restrictive corporate charter or partnership agreement clauses, and other similar features, including the effect on value: USPAP pp. U69, U71; SSVS No. 1, par. 28
  - —Elements of ownership control including law, distribution of ownership interests and contractual relationships, and effect on value: USPAP pp. U69, U71; SSVS No. 1, par. 13, 25, 27, 28, 29, and 40
  - —Effect of marketability or liquidity or both on value: USPAP pp. U69, U71; SSVS No. 1, par. 13 and 40
- Identify any extraordinary assumptions and hypothetical conditions: USPAP pp. U3, U69; SSVS No. 1, par. 22 and appendix C

  Note: SSVS No. 1 does address hypothetical conditions in paragraph 22 and appendix C, but does not directly address extraordinary assumptions. This is a difference between the two standards. USPAP (p. U3) and SSVS No. 1 (p. 53) define a hypothetical condition as "That which is or may be contrary to what exists, but is supposed for the purpose of analy-

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sis." USPAP defines an extraordinary assumption as, "an assumption, directly related to a specific assignment, which, if found to be false, could alter the appraiser's opinions or conclusions." The difference between USPAP extraordinary assumptions and USPAP hypothetical conditions is that an extraordinary assumption presumes, as fact, otherwise uncertain information while a hypothetical condition assumes conditions contrary to those that exist.

- Determine the scope of work: USPAP pp. U70, U12-U13; SSVS No. 1, par. 9, 11, 12, 13, 14, 15, 17, 19, 25, and 44

  Note: Although there are many similarities in requirements, there are some differences between USPAP and SSVS No. 1 concerning the scope of work. USPAP states, "An appraiser must not allow assignment conditions to limit the scope of work to such a degree that the assignment results are not credible in the context of the intended use." *Credible* is defined in USPAP as "worthy of belief." USPAP also states that "The scope of work is acceptable when it meets or exceeds: the expectations of parties who are regularly intended users for similar assignments; and what an appraiser's peers' actions would be in performing the same or similar assignment." SSVS No. 1 does not mention the term *credible* or the phrase *worthy of belief* and does not directly discuss expectations of intended users or an appraiser's peers' actions. However, SSVS No. 1 does address professional competence, objectivity, independence, establishing an understanding with the client, and also "…the extent, if any, to which procedures will be limited by either client or circumstances beyond the client's or the valuation analyst's control." Scope restrictions or limitations under SSVS No. 1 must also be disclosed.

- If the interest has the ability to liquidate, was liquidation value considered: USPAP p. U70; SSVS No. 1, par. 25 and appendix B

  Note: Although SSVS No. 1 has a discussion of the premise of value and definitions of the premises of value, it does not specifically address the ability to liquidate and the consideration of liquidation value.

- Use one or more approaches: USPAP p. U70; SSVS No. 1, par. 4, 11, 21, 23, 25, 31–39, and 44
- Nature and history: USPAP p. U70; SSVS No. 1, par. 12, 13, 23, 25, and 27
- Financial and economic conditions: USPAP p. U70; SSVS No. 1, par. 26, 27, 29, and 44
- Past results, current operations, and future prospects: USPAP p. U70; SSVS No. 1, par. 26, 27, and 29
- Past sales of ownership interests: USPAP p. U70; SSVS No. 1, par. 36 and 37
- Sales of ownership interests in similar businesses: USPAP p. U70; SSVS No. 1, par. 36 and 37
- Prices, terms, and conditions affecting past sales of similar ownership interests: USPAP p. U70; SSVS No. 1, par. 36 and 37
- Economic benefit of tangible and intangible assets: USPAP p. U70; SSVS No. 1, par. 28, 33, 34, and appendix C
- Analyze factors such as holding period, interim benefits, and the difficulty and cost of marketing the subject interest: USPAP p. U71

  Note: SSVS No. 1 does not specifically address these factors.

- Value may not be a pro rata share of the whole: USPAP p. U71

  Note: SSVS No. 1 does not specifically address a pro rata share but does present, in paragraph 40, a discussion of valuation adjustments including a discount for lack of marketability or liquidity and a discount for lack of control.

- Reconcile the quality and quantity of data available and analyzed: USPAP p. U71; SSVS No. 1, par. 30, 42, and 44
- Reconcile the applicability and relevance of the approaches, methods, and procedures used: USPAP p. U71; SSVS No. 1, par. 42 and 44
- Value conclusion is the result of the appraiser's judgment and not necessarily the result of a mathematical process: USPAP p. U71; SSVS No. 1, par. 4, 11, 42, and 44

  Note: There is no specific mention of a mathematical process in SSVS No. 1.

Standard 10: Business Appraisal, Reporting

Now on to the reporting standards (USPAP Appraisal Report compared with SSVS No. 1 Detailed Report).

- Communicate each analysis, opinion, and conclusion in a manner not misleading: USPAP p. U72; SSVS No. 1, par. 51, 52 and by reference 14, 15, and 17
- Standard does not dictate the form, format, or style of a report: USPAP p. U72; SSVS No. 1, par. 48, 51, and 52
- Clearly and accurately set forth the appraisal in a manner that is not misleading: USPAP p. U72; SSVS No. 1, par. 51, 52, and by reference, 14, 15, and 17
- Contain sufficient information to enable intended user(s) to understand the report: USPAP p. U72; SSVS No. 1, par. 51 and 52
- Disclose all assumptions, extraordinary assumptions, hypothetical conditions, and limiting conditions clearly and accurately: USPAP p. U72; SSVS No. 1, par. 51, 52, 65, 66, 68, 69, and 70

  Note: See prior comments on extraordinary assumptions.

Appraisal Report: USPAP p. U72

- The content of the report must be consistent with the intended use: USPAP p. U72; SSVS No. 1, par. 49, 52, 65, 66, 68, and 69
- State the identity of the client and

intended users and the intended use: USPAP p. U73; SSVS No. 1, par. 49, 52, 65, and 69

- Summarize information sufficient to identify the subject interest: USPAP p. U73; SSVS No. 1, par. 51 and 52
- State the extent the interest contains elements of control and why: USPAP p. U73; SSVS No. 1, par. 51, 52, 58, and 63
- State the extent to which the interest lacks elements of marketability or liquidity, or both, and why: USPAP p. U73; SSVS No. 1, par. 51, 52, and 63
- State the standard, definition, and premise of value and cite the source of the definition: USPAP p. U73; SSVS No. 1, par. 52, appendixes B and C
- State the effective date of the appraisal and the date of the report: USPAP p. U73; SSVS No. 1, par. 52, 68, and 69
- Summarize the scope of work: USPAP p. U73; SSVS No. 1, par. 49, 51, 52, 68, and 69
- Summarize the extent of any significant business or intangible asset appraisal assistance, or both, and state the names in the certification: USPAP pp. U73–74; SSVS No. 1, par. 51, 52, 65, and 68

  Note: USPAP requires a summary of the assistance (not in the certification) and statement of the names in the certification. SSVS No. 1 does not require a summary of the assistance, but does require the names in the certification.
- Summarize the information analyzed, the appraisal procedures followed, and the reasoning: USPAP p. U74; SSVS No. 1, par. 51–70
- Exclusion of the market approach, asset-based (cost) approach, or income approach must be explained: USPAP p. U74; SSVS No. 1, par. 59, 60, and 68

  Note: There is no specific requirement in SSVS No. 1 that any exclusion of approaches be explained. However, SSVS No. 1 does state, "This section [59] should state that the valuation analyst has considered the valuation approaches discussed in paragraph 31." And, "In this section, [60] the valuation analyst should identify the valuation methods used under each valuation approach and the rationale for their use."
- Include sufficient information that the appraiser complied with standard 9: USPAP p. U74; SSVS No. 1, par. 65, 68, and 69

  Note: SSVS No. 1 does not reference USPAP standard 9; however, SSVS No. 1 does reference conformity with all the SSVS standards in the report requirements.
- Provide sufficient information to enable the client and intended users to understand the rationale for the opinions and conclusions including reconciliation: USPAP p. U74; SSVS No. 1, par. 51, 52, and 68
- State all extraordinary assumptions and that their use might have affected the results: USPAP p. U74

  Note: See previous comments in the development comparison.
- State all hypothetical conditions and that their use might have affected the results: USPAP p. U74; SSVS No. 1, par. 52
- Include a signed certification: USPAP p. U74; SSVS No. 1, par. 51, 65, 68, 69, and 70

  Note: USPAP requires a "certification," while SSVS No. 1 requires a "representation." They are essentially the same in terms of what they are intended to do.

Certification: USPAP p. U76

- Include a signed certification: USPAP p. U76; SSVS No. 1, par. 51, 65, and 69
- Signing appraiser is responsible for the decision to rely on the work done by appraisers and others who do not sign the certification: USPAP p. U76; SSVS No. 1, par. 65, also SSVS No. 1, par. 20, if applicable.
- Signing appraiser is required to have a reasonable basis for believing that those individuals performing the work are competent: USPAP p. U77

  Note: SSVS No. 1 does not specifically address this USPAP requirement.
- Signing appraiser also must have no reason to doubt that the work of those individuals is credible: USPAP p. U77

  Note: SSVS No. 1 does not specifically address this USPAP requirement.

Oral Reports: USPAP p. U77

- An oral appraisal report must address the substantive matters set forth in the Appraisal Report section [rule 10-2(a)]: USPAP p. U77; SSVS No. 1, par. 78
- If an oral report is given, recordkeeping provisions apply: USPAP p. U77; SSVS No. 1, par. 78

CONCLUSION

Although there are some differences between SSVS No. 1 and USPAP, by far, there are many more similarities. As such, for those analysts who need or wish to conform to both standards, it should not be too much of a problem. Also, USPAP and SSVS No. 1 are minimum requirements, so combining both is acceptable and may result in enhanced analysis and report standards' compliance.

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GETTING THE FACTS BEHIND THE FIGURES

By Mark Filler, CPA/ABV

When attempting to adjust a lost business income claim, the practitioner typically applies quantitative methods based on historical data. However, the practitioner also should investigate the facts behind the figures. Elements of reasonableness, informed judgment, and common sense must come into play when attempting to adjust a lost business income claim; otherwise, the results obtained will be similar to predicting the future with a ruler.

The case of ABC AutoDealer illustrates how uncovering the facts behind the figures can make a difference in the outcome. ABC Auto Dealer (a pseudonym), located in York County, Maine, suffered a fire loss in its parts department on August 17, 2003. The smoke damage affected diagnostic equipment in the service bays, causing a two-day shutdown while cleanup proceeded. The parts department was rendered inoperable from August 17 to September 16. Because of the subrogation potential, the parts department was a protected scene until representatives from other insurance carriers could investigate. Starting on September 16, the demolition and repairs began. They concluded on October 5, allowing ABC's parts department to return to its normal operating capacity. During this latter period, ABC still had a parts department, albeit a makeshift operation, deployed from the back of a box trailer on the site.

ABC AutoDealer submitted a presentation of lost business income that consisted of three elements of loss:

1. The impact on the ability of technicians to do service work
2. Lost profit on parts not sold during the period of interruptions
3. Lost profit to the retail side: Used and new vehicle retail sales were lower than projected.

THE PROBLEM

This loss presented multifaceted variables because the fire had an impact on four out of five sales departments (wholesale used vehicle sales were unaffected by the fire). The insurance carrier's intent was to afford protection for losses that could be directly attributable to the fire. Our firm was asked to determine if any economic, seasonal, industry, or personnel factors may have contributed to lower-than-expected results and then to compute ABC AutoDealer's lost business income.

The fundamental issue we had to deal with was this: How could a small fire in the parts department that shut down the showroom for less than half a day on August 17 cause a $548,000 shortfall in retail vehicle sales in the last 14 days of the month of August 2003? We uncovered the following facts, which made the loss calculation more problematic than usual:

1. The sales manager left the month before the fire.
2. The dealer was having its best year ever up until the time of the fire: Year-to-date sales through July were up 70.3 percent over the same period the year before.
3. Retail vehicle sales activity for the first 14 business days of August 2003 was low.
4. The dealership's owner submitted a pre- and postfire sales summary for August 2003 that didn't agree with that month's dealer financial statement (DFS). His submission increased the potential loss, and when the discrepancy was brought to his attention, he refused to acknowledge or correct it.
5. Prior to 2003, there was neither an upward or downward trend to either parts or new and used vehicles sales, nor was there a strong seasonality factor.

DOCUMENTS AND DATA REVIEWED

After we contacted ABC's CPA, we received copies of the 70 monthly DFSs for the period January 1998 through December 2003. We also received copies of the insured's federal income tax form 1120S for the calendar years 2000, 2001, and 2002, and a breakdown of vehicle sales in dollars and units for both new and used retail vehicles for the pre- and postfire days of August 2003. We conducted telephone interviews with the owner, the general manager of another dealership, and the controller of a third dealership to ensure that we were reading and interpreting the DFSs correctly. From the State Planning Office website, we obtained retail sales for the same 70-month period of the store-type group labeled "auto-transportation" for both the state of Maine and York County.

ANALYSIS

We then graphed the 70-month data, dividing the categories by 10,000; 1,000; and 100 for ease of comparison. We found that ABC Auto Dealer's sales somewhat loosely followed the sales patterns established by the state and the county. The same pattern was repeated when we compared the sum of sales for the latest 12 months with the sum of sales for the previous year's 12 months. The comparison revealed that the sum of monthly sales for the 12 months ending August 2003 was 22.1 percent higher than the sum of the 12 months' sales for the year ended August 2002. Up through 2002, the company generally followed the growth patterns exhibited by the state and the county. However, because a new sales manager was hired at the end of 2002, ABC had shown substantial growth in 2003 when compared with county and state growth trends.

We then analyzed sales of the insured's four major profit centers for the 70-month period in four categories: new vehicles, used vehicles, parts, and service. Sales dipped for the month of August 2003 in three of the four categories—used retail sales actually had an upward tick. What was more compelling, however, was the restoration of sales activity to approximately normal levels in the succeeding months of September and October for new vehicles and parts and service. This was surprising because the sales manager had yet to be permanently replaced. The owner was filling that position *ad interim*.

Because of a great deal of noise in all four sales categories, a complex forecasting technique such as time-series analysis, controlling for trend, seasonality, and October 2001's abnormally high sales, and after transforming the dependent variable, can produce forecasts that have an r^2 of only about .70. Given the variability of the data, we felt that this goodness-of-fit metric was too low for us to rely on the regression output to forecast August sales. Econometric regression also failed because the coefficient of correlation between ABC's sales and either state or county auto sales was so low that the r^2 produced for both independent variables was only around .50. Even if these techniques had forecasted August 2003's sales with a greater degree of accuracy, the forecasted amounts would not have reflected the adverse impact of the loss of the sales manager: the comparatively low retail vehicle sales prior to the date of the fire. Therefore, we had to turn elsewhere for a solution.

Another way of getting an idea of what August's maximum sales for new and used vehicles could have been, but for the fire, was to calculate the average percentage of sales that August represented for each annual ten-month period from January to October, and then compare this average to the actual percentage obtained for August 2003.

Obviously, as Table 1 shows, sales are down for August when compared with the average, especially for new vehicle sales, when compared with just the prior year. Using Excel's Solver, I back-solved for the amount of sales in each category for August 2003 such that the amounts generated equaled the five-year average percentage. Table 2 shows the amounts computed and compares them to actual sales for August 2003.

Table 1. Average Percentage of August Sales, 1998–2003

Year	Retail-New	Retail-Used
1998	14.0%	11.4%
1999	12.0%	15.2%
2000	8.9%	12.9%
2001	15.4%	16.2%
2002	18.7%	13.9%
Average August	13.8%	13.9%
August '03	10.5%	12.2%

Although the amount of potential lost sales was the maximum that could be obtained, it did not reflect the effect that the loss of the sales manager had on sales. In the auto dealer world, sales managers are much like star athletes—they always want to renegotiate their contracts during a stellar season. The ABC dealership owner would not hear of this and instead fired the sales manager in July 2003, in the middle of the best year the dealership ever had. The impact on August sales was dramatic, forcing us away from relying on any conventional forecasting techniques and towards relying on an industry rule-of-thumb that the dealership's owner provided himself: Sales are not earned ratably throughout the month.

In addition to the rule-of-thumb, the owner provided data that indicated that unit sales for the pre- and postfire periods were 42 and 37 respectively. He also provided the amount of sales dollars for the two periods. Although the sales dollars totals for used retail vehicles agreed with the DFS for August 2003, the sum of new vehicle sales dollars did not. The insured would not assist us in resolving the discrepancy. We resolved it, however, by assuming the same product and price mix postfire as prefire and apportioned the sales dollars in accordance with the number of vehicles sold in each period.

During the prefire period, August 1–17, there were 14 sales days, resulting in average daily sales of $43,107 for new and $28,376 for used retail vehicle sales. Assuming no increasing trend in sales for the next six sales days, August 19–24, total sales for the first two-thirds of the month, or the first 20 sales days, would have been $1,429,654. The owner had informed us, and we verified with a tax client of our firm who is the general manager of the largest dealership in northern New Hampshire, that one-third of a typical dealer's monthly sales come in the last week of the month. Extrapolating from the first 20 days' expected sales gave us total vehicles sales of $717,720 for the last six selling days of August 2003 and total expected vehicle sales of $2,144,374 for the month. Actual vehicle sales for the month were $1,882,907, a shortfall of $261,467 or 12.2 percent of expected vehicle sales.

Table 2. Comparison of August Sales Based on Average Percentage With Actual Sales

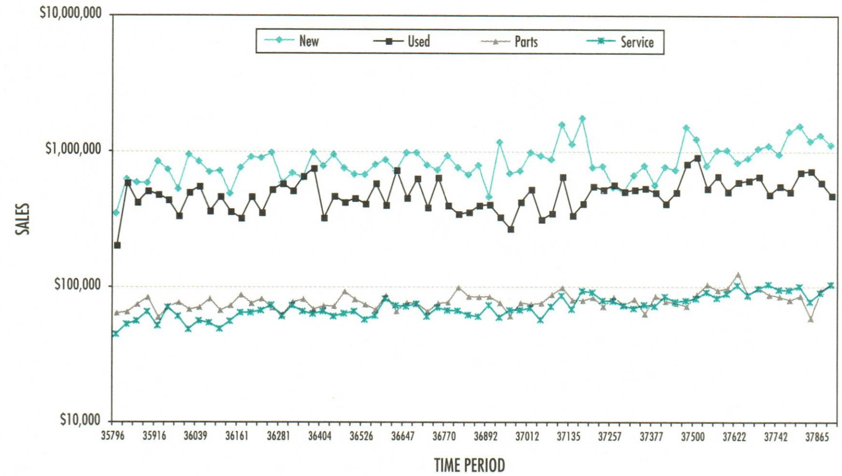
	August sales volume based on average %	Actual August	Difference
Retail-New	$1,601,087	$1,170,732	$430,355
Retail-Used	829,746	712,175	117,571
Total	$2,430,833	$1,882,907	$547,926

The owner complained that the sales projected by using this method were too low, even though he had suggested the method to us. We encouraged him to submit evidence that some or all of the months from January 2003 through July 2003 had sales activity that contravened his own rule of thumb; that is, that those months had 41 percent of their sales in the last quarter of the month, which the dealership would need to have done in August 2003 to create the $548,000 of missing sales, rather than 33.3 percent per the "rule." He never responded to the challenge, but he did try to puff up the claim by submitting a handwritten pre- and postfire sales listing for August 2003 that did not agree with the DFS as mentioned above. Total retail vehicle sales dollars were higher than the DFS, with the excess attributed to prefire sales, which had the effect of increasing the potential loss.

From the $261,467 amount of lost vehicle sales, we must subtract saved expenses that come in three varieties for this sales category. The three varieties, for which the nomenclature is taken directly from the DFS, are *direct cost of sales, variable expense,* and *semi-fixed expenses.* The percentage of sales to be deducted for cost of sales and variable expenses is computed from the DFS's year-to-date amounts through July 2003 and was done separately for both new and used retail vehicle sales, as shown in Table 3.

We calculated saved semi-fixed expenses using regression analysis to determine the variable portion for that variety of expense. We regressed 67 months (through July 2003) of semi-fixed expenses against sales for both new and used retail vehicle sales. The regression output indicated that for every dollar of increase in sales, semi-fixed expenses increase $0.0089 and $0.0157, respectively, for new and used retail vehicle sales. Both model's *p* values are less than 5 percent, and both F statistics are greater than 4 (F [1, 65, .95]), indicating that each slope value and each regression as a whole is statistically significant. The low r^2 s coupled with the high t statistics merely indicated that other factors drive, or explain, semi-fixed expenses besides sales. However, this is of no matter, since we are only concerned with the impact of sales on this category of expense, which this regression equation handles quite nicely.

Exhibit 1. Retail Sales by Category—January 1998–October 2003



(These numbers indicate every fourth month in the time period.)

For parts and service, there was no industry rule of thumb to rely on, so we used a different technique. As Exhibit 1 illustrates, although service sales had been trending upward since 1998, they were relatively flat since February 2003. Parts department sales, having no appreciable trend were, therefore, also relatively flat after February 2003 onward. We calculated the coefficient of variation of the sales for both departments for February through July and for September and October 2003 and found them to be 9.3 percent for parts and 6.5 percent for service. With this little variation in the data, we tried another forecasting technique.

It is obvious from Exhibit 1 that the parts and service departments had below normal sales in August 2003. The computation of that abnormality is shown on Exhibit 2, where we have computed the average monthly sales and the standard deviation for that average for the months of February through July and September through October 2003 (January was excluded because its sales were abnormally high). Ninety-five percent of all average monthly sales will fall between the

Table 3. Sales, Cost of Sales, and Variable Expenses—January 2003–July 2003

	New	Used	Parts	Service
Sales ($)	7,611,088	4,079,270	636,544	661,646
Cost of sales ($)	7,260,148	3,700,565	449,422	46,948
Cost of sales (%)	95.39%	90.72%	70.60%	7.10%
Variable expenses ($)	67.942	127.004	—	—
Variable expenses (%)	.89%	3.11%	—	—

average and plus or minus 2.365 standard deviations, or between $69,199 and $108,037 for parts, and between $79,281 and $108,318 for service. Any monthly sales figures outside this range can be deemed abnormal, which would include the month of August for both departments.

We computed lost sales by subtracting actual monthly sales from the expected monthly sales, which was deemed to be the eight-month average monthly sales figure. Cost of sales was computed from the DFS year-to-date amounts through July 2003 as shown in Table 3. Other saved expenses were then computed using regression analysis as described previously.

We also computed the lost business income from the finance and insurance (F&I) department and the Adjustments to Income account. The monthly amount of net F&I income was regressed against monthly new and used retail vehicle sales to determine the amount of incremental net F&I income explained by changes in sales. We followed the same procedure for Adjustments to Income, except we used total sales from the four departments as the independent variable. The penultimate calculation was for the saved expense, employee bonuses, which was performed in the same manner as was used with Adjustments to Income.

The total claim for lost business income was calculated to be $29,667. The amount of lost business income does not include any amount from the used wholesale vehicle department, nor does it include any income from the manufacturer rebate for the customer satisfaction adjustment. This is because the fire should not have affected wholesale sales, and customer satisfaction adjustments are lagged responses to dealership activities in prior months. Therefore, lost revenue, if any, would be received outside the time limits afforded by the policy. In fact, through October 2003, 50 percent of the dealership's profit before taxes was generated by the customer satisfaction adjustment from the manufacturer.

Exhibit 2. Calculation of Abnormally Below Average Sales—Parts and Service Departments

	SALES	
	Parts	Service
Feb-03	$84,195	$84,010
Mar-03	96,404	94,483
Apr-03	85,947	101,376
May-03	83,634	92,268
Jun-03	78,590	91,981
Jul-03	84,336	97,762
Aug-03	57,845	75,511
Sep-03	92,091	87,610
Oct-03	103,750	100,907
Monthly Average, Feb–Jul, Sept–Oct	88,618	93,800
Standard Deviation	8,212	6,140
Critical value of t	2.365	2.365
+/– range	19,419	14,518
95% Confidence Level from	69,199	79,281
95% Confidence Level to	108,037	108,318

August sales fall outside the 95% confidence range

INSURED'S CLAIM SUBMISSION

The insured, through its CPA, submitted a claim with a high and a low figure, $144,368 and $110,492 respectively. The high figure was based on the logic that the rate of year-to-date growth in profits of 252 percent through July, including all departments plus other income and manufacturer's rebates, over the 2001–2002 average, would have continued into August. The low figure was based on the logic that the rate of year-to-date growth in unit vehicle sales of 35 percent through July, over the 2001–2002 average, would have continued into August. The logic was similar for the service department, but with no consideration given to other income and manufacturer's rebates. Both of these arguments are circular in that they assume what they need to prove: that 2003's rate of increase in sales over the average of the two prior years would have continued into August at the same pace exhibited from January through July, in spite of the loss of the sales manager. What is missing from the insured's claim is discussion of the unit sales count up to the date of the fire and the impact that count could have had on total unit sales for the month.

In one way, this was a typical lost business income claim. The amount claimed by the insured made no sense when measured against the facts that we knew concerning the extent of the fire and smoke damage and the amount of time each department was actually shut down after the fire. In another way, it was atypical. There was a tremendous fall-off in sales in August 2003.

These two incongruous facts had to be reconciled. By gathering as much quantitative evidence as we could through the 70 monthly DFSs, and as much qualitative information as we could by interviewing people knowledgeable about the industry, we were able to uncover the two most important facts about the loss: The firing of the sales manager the month before the fire and the concomitant poor vehicle sales during the first 17 days of August allowed us to rationalize the insured's poor performance without having to resort to the fire's consequences as an explanation.

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Expert TOOLS

FOCUSING ON ESOP VALUATION ISSUES

A review of the Guide to ESOP Valuation and Financial Advisory Services, *second edition, by Robert F. Reilly and Robert P. Schweihs*

By William C. Ludwig

The *Guide to ESOP Valuation and Financial Advisory Services,* second edition, expands and updates the information from the first edition published in 2005. The book is primarily a compilation, adaptation, and expansion of articles written by the authors over the past several years and reflects the current thinking of professional practitioners on employee stock ownership plans (ESOP) valuation issues. Little text is devoted to "how to" value a business. Rather, the focus is primarily on uses of valuation reports and related issues.

AUDIENCE

The book is targeted primarily toward other professional practitioners. Consequently, it will be useful to the following professionals:

- ESOP trustees
- ESOP legal counsel
- ESOP accountants and auditors
- ESOP administrators
- ESOP financial advisors

However, a broader audience, which could include the following people, will also find value in this publication:

- ESOP sponsors and potential sponsors
- Employer management
- Non-ESOP stockholders
- Plan participants

CONTENT

The book is logically organized and begins with issues related to structuring the ESOP transaction. This section includes discussions of the common uses of ESOPs and the tax benefits arising from the same. The next section focuses on basic stock valuation issues and includes a discussion of the differences associated with valuing large and small corporations.

From there, the book moves on to more advanced valuation issues, including different approaches to the valuation process and various adjustment factors that might influence a valuation. Chapter 14 provides a good introduction to the impact of the employer stock repurchase obligation on the valuation.

Sections IV through VI provide numerous examples of the various uses of financial advisor (that is, valuation) services. These uses range from fairness opinions to solvency determinations, reasonableness of compensation, litigation support, and expert witness testimony. Checklists are provided for valuation and fairness opinions as well as for solvency opinions.

The last sections of the book contain sample reports for several ESOP-related purposes—one for a proposed ESOP transaction including a fairness opinion and one for an existing ESOP valuation. There is also a sample case study to determine the reasonableness of executive compensation. The authors make clear what goes into such reports including the analysis, rationale, and conclusions. The samples show the end user what one should expect from a competent financial advisor and can serve as a benchmark against which similar reports can be prepared.

This second edition of the *Guide* is a valuable addition to any ESOP practitioner's library. At almost 600 pages, it will serve as an excellent reference tool. Priced at $59.95, it can be purchased from Willamette Management Associates online at www.willamette.com/books.html.

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Expert TOOLS

PULLING VALUATION CONCEPTS TOGETHER

A review of Business Valuation: An Integrated Theory, *second edition, by Z. Christopher Mercer, ASA, CFA, and Travis W. Harms, CFA, CPA/ABV (Hoboken, NJ: John Wiley & Sons, Inc., 2008)*

By James R. Hitchner, CPA/ABV, ASA

The following review is reprinted with permission from the Jim Hitchner's Financial Valuation and Litigation Expert, *February/March 2008. For more information about this informative, bi-monthly professional journal, visit* www.valuationproducts.com.

As I started reading the second edition of this insightful book, I immediately noticed a difference from the first edition: This second edition is easier to read. Mercer and Harms have done an excellent job of explaining how business valuation is not just about separate approaches, methods, procedures, and applications. It is also about how these elements are all connected and how they relate to each other.

The first chapter, "Discounted Cash Flow and the Gordon Model: The Very Basics of Value," is anything but basic. It makes you think about the relationship between earnings, cash flow, reinvestment, dividend payout ratios, rates of return, and the different types of growth. This chapter alone makes the book worth buying. However, there is much more to read, learn, and think about.

Chapter 3, "The Integrated Theory of Business Valuation," and chapter 4, "Adjustments to Income Statements: Normalizing and Control Adjustments," explain the authors' views on levels of value, including minority marketable, financial control, strategic control, and nonmarketable minority. They also dive into normalizing adjustments and the nature and source of control premiums and whether they are useful or not.

Chapters 7, 8, and 9 introduce the Quantitative Marketability Discount Model (QMDM), its assumptions and application. Mercer and Harms have expanded this section from the first edition and provide a thoughtful presentation of this model. At its foundation, the QMDM is "...a shareholder level discounted cash flow model..." and "...a valuation method within the income approach." They also state that "The QMDM inputs are analogous to those used in traditional enterprise level discounted cash flow models." And they say that, "Although the QMDM directly values the subject nonmarketable minority interest, it is not used in isolation, but rather in conjunction with a contemporaneous valuation of the subject enterprise because the shareholder expectations regarding cash flows, risk, and growth are inextricably linked to the corresponding expectations with respect to the enterprise."

One criticism we often hear about the QMDM is that it is very sensitive to assumptions and inputs to the model. Mercer and Harms answer that criticism head on: "Appraisers and many users of appraisal reports are well aware of the sensitivity of value indications based on the enterprise level DCF valuation method to changes in key assumptions such as projected margins (and interim earnings growth), the discount rate, the capital structure assumption, and the expected growth in earnings (or the multiple selection) for the terminal value estimate. Sensitivity to assumptions in valuation is simply a fact of life. What is important is to make reasonable assumptions given the pertinent facts and circumstances. Because QMDM is a shareholder level discounted cash flow model (DCF), sensitivity to significant changes in assumptions is no surprise."

The required holding period and required holding period returns are two other controversial areas. For the required holding period, the authors state, "Business appraisers cannot be expected to know the unknowable. But appraisers can make decisions regarding the likelihood of a relatively short expected period versus a relatively long expected holding period. And, given the particular facts of a situation, those general assessments can often be more narrowly refined. In the final analysis, the appraiser must make an explicit assumption regarding the expected holding period." This is obviously one of the most important and difficult assumptions that are made in this model and where differences of opinion may occur.

For the required holding period returns and the use of investor-specific risk premiums for the investment, the authors state, "Ultimately, holding period premiums are analogous to the company-specific risk premium used to derive enterprise discount rates. Most appraisers are comfortable estimating such company-specific risk premiums. There are no studies to help appraisers make such estimates. Nevertheless, appraisers make reasonable assumptions in the context of their experience, judgment, common sense, reasonableness, and comparisons with alternative returns available in the marketplace.... It would be inconsistent to accept appraiser judgments in enterprise discount rate development but to criticize them in shareholder level discount rate development." It seems that the authors are saying that "the pot is calling the kettle black."

Whether you agree with the authors or not, and some of the concepts presented are controversial, the bottom line here is that two smart appraisers have written an eye-opening book that presents their theories in an understandable manner, while also providing detailed applications, models, examples, and cases. This book makes you think hard about the mechanics of business valuation and how they are all connected. This is a worthwhile read.

THE AICPA 2008 TOP TECHNOLOGY INITIATIVES

The technologies expected to have an impact on your firm and client organizations.

According to the 19th Annual American Institute of Certified Public Accountants' Annual Top Technology Initiatives survey, information security management will be the most important initiative affecting IT strategy, investment, and implementation in business organizations over the next 12 to 18 months. IT governance is the second highest priority, which reflects the market's renewed emphasis on corporate governance and responsibility.

The AICPA conducted the poll in the fall of 2007, together with the Information Systems Audit and Control Association (ISACA), the Institute of Internal Auditors (IIA), and the Information Technology Alliance (ITA). A group of 1,169 CPA certified information technology professional (CITP) credential holders, auditors, and IT executives identified the top 10 most important technology initiatives for 2008 as follows:

1. Information Security Management
2. IT Governance
3. Business Continuity Management and Disaster Recovery Planning
4. Privacy Management
5. Business Process Improvement, Workflow, and Process Exceptions Alerts
6. Identity and Access Management
7. Conforming to Assurance and Compliance Standards
8. Business Intelligence
9. Mobile and Remote Computing
10. Document, Forms, Content, and Knowledge Management

A description of each of these top ten technologies can be found online at infotech.aicpa.org/Resources/Top+Technology+Initiatives/2008+Top+10+Technology+Initiatives/2008+Top+Technologies+and+Honorable+Mentions.htm.

IMPACT OF INFORMATION SECURITY MANAGEMENT

Although each of these initiatives can have certain impacts—and benefits—on your firm and clients, information security management was rated the number one issue for the sixth year in a row in the AICPA Top Technology Initiatives Survey. The repetition of this first-place status demonstrates the real challenge that private businesses, large organizations, and even the federal government have protecting their most sensitive information assets from viruses, hackers, and data breaches. As an example, according to a recent *Forbes* article, the U.S. government received a C– rating in its annual report evaluating how well its agencies meet the conditions of the Federal Information Security Management Act.

IMPACT OF IT GOVERNANCE

Respondents indicated their second most important technology initiative is IT governance. Many sources agree about the importance that a sound IT governance strategy can have in an organization's need to gain maximal use of IT resources and overall performance.

For example, the information technology consulting firm, Gartner, Inc., believes this initiative is so important that they hold an annual summit focusing on the tools, technologies, strategies, and tactics to improve governance, assess risk, and ensure compliance within organizations. Also, the Harvard Business School Press conducted and released results of a study on IT governance, surveying 256 Chief Information Officers (CIOs) plus 40 interview-based case studies at large companies such as Johnson & Johnson, Carlson Companies, UPS, and Delta Air Lines that concluded, "...when senior managers take the time to design, implement, and communicate IT governance processes, companies get more value from IT." (Weill, P., and Ross, J. W., 2005, *A Matrixed Approach to Designing IT Governance,* Harvard Business School Press, Boston.)

As an element of corporate governance, IT governance is established so that key stakeholders, such as board-level executives, department heads, and other personnel who may have limited technical experience, can be informed and educated about the IT technologies and processes in the organizations they govern so that they can meaningfully participate in the organization's key decisions related to IT. Doing so can help increase the value of IT and manage the risks associated with IT within an organization.

NEW DEBUTS AND HONORABLE MENTIONS

Although information security management and IT governance ranked first and second, two technology initiatives made their debut in the top ten technology initiatives expected to have an impact on organizations this year: business process improvement, workflow, and process exception alerts (number 5), and business intelligence (number 8).

Simply put, according to *Wikipedia,* "business process improvement (BPI) is a systematic approach to help any organization make significant changes in the way it does business."

Business intelligence (BI) emphasizes accessing and presenting information in a useable format, which is at the heart of BI technologies. BI gives individuals access to information with the ability to "slice and dice" it in a variety of forms for relevant analyses on an as-needed basis, making their decisions more informed and timely. Both of these technology initiatives have had a lot of publicity in recent years, and new approaches and tools are available for organizations to leverage in their technology plans.

In addition to the above list, the AICPA also captured the next five most important technology initiatives as honorable mentions. These included the following:

11. Customer Relationship Management
12. Improved Application and Data Integration
13. Training and Competency
14. Web-deployed Applications
15. Information Portals

For detailed definitions and additional information on all the 2008 Top Technology Initiatives, go online to infotech.aicpa.org/Resources/Top+Technology+Initiatives/2008+Top+10+Technology+Initiatives/2008+Top+Technologies+and+Honorable+Mentions.htm#hm.

To learn how you can access the valuable resources, guidance, and tools available to the AICPA IT section members for use when considering or implementing some of these initiatives, go online to infotech.aicpa.org/toptech.

AICPA VALUATION STANDARD AND IMPLEMENTATION TOOLKIT AVAILABLE

As you know, The Statement on Standards for Valuation Services No. 1 (SSVS No. 1), *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset,* (AICPA, *Professional Standards,* vol. 2, VS sec. 100) is effective for business valuation (BV) engagements accepted by members after January 1, 2008. You can download a copy of SSVS No. 1 at fvs.aicpa.org/Resources/Laws+Rules+Standards+and+Other+Related+Guidance/AICPA+Valuation+Standard+and+Implementation+Toolkit.htm. This website also provides a link to the AICPA Valuation Standard and Implementation Toolkit. The toolkit has several sections, which consist of an overview, tools, glossaries and illustrations, and additional resources to aid a practitioner in following the SSVS No. 1.